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IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-624

FRANK LYON COMPANY, *Petitioner,*

v.

THE UNITED STATES, *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

REPLY MEMORANDUM FOR THE PETITIONER

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PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

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This reply to the Government's brief in opposition is filed because the Government has failed to face the important issues of equity, tax administration, and precedent presented by the decision below.

1. The principal difficulty with the position of the Government, and the approach of the court of appeals,

is the failure to recognize that taxpayers must plan, and that the Internal Revenue Service should tax such transactions in a fashion which is at least roughly predictable. On the practical as well as the conceptual level, it is proper that this transaction should be taxed as the parties understood it.

On the most simple common-sense level, the taxpayer and Worthen both had substantial and legitimate nontax motives for entering into the transaction and organizing it as they did.[1] They planned in good faith for certain consequences and bargained at arms length on those assumptions. And there is no practical reason not to tax the transaction as it was planned and structured. There is no revenue difference—corporate rates are flat rates and the Government will get the same tax from the petitioner, under its contention, as it would get from Worthen under the Government's contention. The Government's position is primarily formal—to no practical avail—while completely upsetting the reasonable expectations of the parties.

The Ninth Circuit in *Cubic Corporation* v. *United States*, 541 F.2d 829, recognized that the intention and situation of the parties should be a substantial factor in determining tax consequences; there should, in short, be some reason for upsetting good faith tax planning untainted by sham. The Government attempts to distinguish *Cubic* by pointing out that *Cubic* did not involve a sale and leaseback. But the Government fails to show any reason why the intent of the parties should be important in determining whether there was a "sale" in *Cubic* and yet irrelevant here. *See also*

[1] For instance, the terms of the agreement were formed to meet requirements of banking law, and by the competition among bidders.

American Realty Trust v. *United States*, 498 F.2d 1194, 1198-99 (4th Cir. 1974).[2]

2. There is no indication in the Government's brief of how the uncertain "bundle of sticks" approach adopted by the court below can be reliably or predictably used to discern the "economic substance" of a transaction.

In two footnotes (Brief in Opposition at 9-10, nn. 9, 10), the Government dismisses all consideration of predictability in general and fairness to the particular parties, observing that tax consequences must follow "economic substance." But here significant aspects of the "substance" of the transaction are given little or no weight. The Lyon-Worthen agreement was an *arms-length transaction* between two commercial actors, there was no *differential in tax rate* between the two parties, and both had *substantial nontax reasons* for entering into the transaction in its present form. Although there is no contention that the transaction is a "sham," or that tax avoidance was the objective or the result, the bargain is scrambled and the expectations of the parties frustrated.

3. The Government's position is that the Frank Lyon Company's share of the benefits and burdens of ownership is simply insufficient to allow it to take depreciation deductions.

[2] Earlier cases have likewise emphasized the importance of the intent of the parties in determining the "economic substance" of the transaction involved. *See, e.g., Helvering* v. *Lazarus & Co.*, 308 U.S. 252 (1939); *Western Contracting Corporation* v. *Commissioner*, 271 F.2d 694 (8th Cir. 1959); *Oesterreich* v. *Commissioner*, 226 F.2d 798, 801-802 (9th Cir. 1955); *Commissioner* v. *H. F. Neighbors Realty Co.*, 81 F.2d 173 (9th Cir. 1936).

The factual difficulties with this conclusion are outlined in the Petition at 13-16 and throughout the opinion of the district court. Pet. App. A. It is illustrative to note that the Government has made no attempt to explain away the 10-year period between the end of the building lease and the end of the ground lease.[3] During this period, Lyon was at liberty to use or rent the property as it wished while paying the specified ground rental of $10,000 per year. This residual interest makes it clear that petitioner was not a mere "conduit" for loan money as the Government and the court of appeals have asserted.[4]

[3] By citing this fact, petitioner does not, of course, accept the Government's characterization of the other burdens and benefits retained by Lyon. This terminal period is merely the clearest example of the Government's refusal to recognize any part of the "substance" of the transaction which does not comport with its own conceptualizations.

[4] The Government relies in its Brief in Opposition far more heavily on Worthen's reversionary interest in the building than did the court of appeals. In its statement of the question presented and in its discussion of *American Realty Trust*, *supra*, the Government states as fact its conclusion on reversion, though it is a disputed question of Arkansas law which the court of appeals stated that it "need not resolve". Pet. App. 27a, n.6. This question, too, materially affects the "conduit" theory on which the Government's case depends.

The common law rule cited by the Government—that improvements by a lessee revert to the owner at the end of the lease unless the lease provides otherwise—does not deal with the more complicated situation presented here, where the ground lessor has *sold* the improvement to the lessee without any reservation of reversionary rights.

Arkansas law clearly recognizes that one person may own the leased land and another may own the improvements thereon. In *Stirman* v. *Craven*, 33 Ark. 376 (1878), the Arkansas Supreme Court resolved the dilemma of dual ownership of the land and building after the termination of the lease by ordering the property sold and the purchase price divided in proportion to value. *Stirman* followed an earlier case, *Witherspoon and Gilliam* v. *Nichols, Sheriff*, 27 Ark. 332 (1871), was cited with approval in *Butler* v. *Adler—Goldman Commission Company*, 62 Ark. 445, 450, 35 S. W. 1110, 1111 (1896), and in *Storthz* v. *Sauger*, 108 Ark. 154, 161, 156 S. W. 1020, 1122 (1913) and has never been overruled or questioned.

Where the Government does attempt to meet the petitioners' arguments concerning the burdens and benefits of ownership which petitioner bears under the arrangement, its position ignores the practicalities of the situation. Thus, when petitioner points to the fact that it could have sold the building at a profit (Pet. at 16) the Government does not dispute the fact, it merely concludes that, since petitioner could not sell the land, sale profit would reflect appreciation of lease rights and not the building itself. (Brief in Opposition at 8, n.6). This hypertechnical distinction not only ignores rights beyond lease rights which would be conveyed (the right to resale and the other burdens and benefits of ownership which the petitioner points out in its brief), it fails totally to reconcile any appreciation on a sale with its "conduit" theory of petitioner's participation.

In a similar manner, the Government argues that petitioner could not realize any profit or loss on condemnation of the building because the lease required that petitioner pay over to Worthen the amount necessary to restore or replace the leasehold. (Brief in Opposition at 8, n.6). This argument ignores the possibility that the amount necessary to restore or replace the leasehold property may not be the same as the amount of insurance or condemnation proceeds.

Finally, the Government asserts that the risk of Worthen's insolvency is no different than the risk faced

by the guarantor of a loan. (Brief in Opposition at 9). This does not mean that the risk is not a risk of ownership. Nor does this argument deal with the possible opportunity presented by a Worthen insolvency if insolvency leaves the petitioner free to deal with a building that has appreciated in value free of the lease.

Moreover, the conclusion that Lyon was a mere conduit, and the factual determinations and assessment which support that conclusion, were fully rejected by the district court as trier of fact. (See Pet. App. A; Pet. at 7.) The district court found that the option prices represented a "negotiated estimate . . . as to fair market value of the building," but the Government simply rejects this finding. (Brief in Opposition at 7.) The Government is asserting that it understands the dynamics of the negotiation better than the trier of fact, and rejecting the plausible conclusion that the terms were what they were because competition for the investment opportunity put Worthen in a position to demand the terms on which the parties agreed. Pet. at 7; Pet. App. A 13a, 10a.

4. A full appreciation of the facts is necessary to determine the "economic substance" of a transaction. The Government's position—that "economic substance" can and should be determined as a pure matter of law—is a dangerous misreading of the law.

The cases cited by the Government (Brief in Opposition at 13) can be taken as supporting the proposition that when the facts are established the determination of the question whether such agreements are to be taxed as sales or financing transactions is ultimately a legal conclusion. The cases cited do not support the idea that courts of appeals should determine the

facts *de novo* in utter disregard of the findings of the trier of fact; yet this is what the Government seeks here, because in *Lyon,* the findings of the district court upheld the taxpayer at every point.

Although the Government cites *American Realty Trust* v. *United States,* 498 F.2d 1194 (4th Cir. 1974), for instance, the *American Realty Trust* court dealt only in the alternative with the Government's contention that a sale-leaseback could be dealt with *de novo* as a matter of law. The court had declared itself "disinclined to disturb the jury's verdict" since there was enough supporting evidence to preclude a conclusion that the verdict on the sale or financing arrangement question was clearly erroneous. 498 F.2d 1198. The ultimate conclusion may be legal but it must be "grounded in underlying findings of fact." 498 F.2d at 1198.

The *American Realty Trust* court's treatment of the issue as a whole, with its full recognition of the importance of the factual findings and the intent of the parties, provides sharp contrast to the decision of the court of appeals here, and the approach the Government urges on this Court. The two approaches, with their conflicting signals to tax planners, cannot be reconciled except by this Court.

5. In its discussion of this Court's decision in *Commissioner* v. *First Security Bank of Utah,* 405 U.S. 394, the Government has simply scrambled what went on when this transaction was carried out. It says (Brief in Opposition 12-13): "Since the federal and state banking authorities approved the sale and leaseback transaction (*See* Pet. App. A 4a), the rule of *First Security Bank* is inapplicable here."

Yet, it is entirely clear that both federal and state banking authorities refused to approve an arrangement under which Worthen would be the owner of the building.[5] It was because of this that Worthen decided to sell the building to the petitioner, and then to lease it back. It is true that the state and federal banking authorities approved this transaction; but the very reason that they did so was because Worthen was *not* the owner of the building under the agreement between the parties. To say that the petitioner should now be taxed as if Worthen was the owner of the building, and that "*First Security Bank* is inapplicable here" is to stand the transaction on its head. What the banking authorities approved was an arrangement in which Worthen was the lessee. This was the view of the court of appeals. Pet App. 16a. For the Government now to say that "The Federal banking law does not prohibit Worthen from borrowing the money but simply required it to seek the approval of the regulatory authorities" (Brief in Opposition 12), when the Federal banking authorities had expressly disapproved an arrangement under which Worthen borrowed the money and was the owner of the building, is disingenuous.

[5] In footnote 3, page 4, of its Brief in Opposition, the Government erroneously stated that the State Bank Department required a repurchase option at the end of the 15th year of the lease, "but did not otherwise specify the terms of the agreement." It is questionable whether the State Bank Department would have approved an option price at fair market value rather than an agreed upon "figure" or dollar amount.

CONCLUSION

The Government has failed here, as the court of appeals failed below, to reconcile the decision below with the findings of the district court, with applicable precedent, or with the dictates of practical foreseeability and sound tax administration. In order to provide badly needed clarity in this field, the Court should grant the petition for certiorari.

Respectfully submitted,

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February, 1977

SUPREME COURT, U.S.

Apr. 16	Transcript of Trial proceedings, filed.
Sept. 1	Opinion, filed (Madden). Copies mailed.
Sept. 21	Judgment of Dismissal in Favor of the defendant The United States of America, and against the Plaintiff Leeds and Lippincott Company, with costs, filed (Madden). Notice mailed.
Oct. 7	Letter waiving all costs except Attorneys' Docket Fee, filed.
Oct. 7	Defendant's costs taxed at $20.00, filed.
Oct. 19	Notice of appeal, filed Oct. 15, 1959 (copies mailed Clerk, USCA and U. S. Attorney).
Oct. 19	$250.00 deposited in Registry of Court and Bond for Costs on Appeal, filed 10-15-59.

OPINION.

(Not for Publication.)

(Filed Sept. 1, 1959.)

APPEARANCES:

For Plaintiff: JAMES N. BUTLER, Esq.; Of Counsel: CONVERSE MURDOCH, Esq., and KENNETH W. GEMMILL, Esq., both of Pennsylvania Bar.

For Defendant: CHESTER A. WEIDENBURNER, Esq., United States Attorney; FRANK J. FERRY, Esq., Assistant United States Attorney; CHARLES K. RICE, Esq., Assistant Attorney General; JAMES P. GARLAND, Esq., and FRED J. NEWLAND, Esq., Attorneys, Department of Justice.

MADDEN, District Judge:

This is a suit instituted by plaintiff, Leeds and Lippincott Company, a corporation of New Jersey, hereinafter referred to as taxpayer, to recover federal income taxes for the years 1950 and 1951 allegedly paid in error to the Collector of Internal Revenue for the District of New Jersey. Claim for refund was properly made and no disposition thereof having been made within six months this suit was instituted in accordance with the statute.

The facts of this matter, with the exception of a comparatively minor detail, are not in dispute and are covered by two stipulations entered herein. While some portions of the stipulations are agreed to in fact they have been objected to upon the grounds that such portions are neither material nor relevant. In passing, the Court has considered all portions thereof as properly admitted.

Plaintiff-taxpayer in 1950 was the owner of boardwalk hotel properties in Atlantic City, New Jersey, known as the Chalfonte-Haddon Hall. These two hotels are actually contiguous to each other, both fronting on the boardwalk, with the Chalfonte on the westerly side of North Carolina Avenue and the Haddon Hall on the easterly side of the same street. It might be well to keep in mind that at this particular location the boardwalk runs generally east and west with the ocean to the south and the land side to the north. On North Carolina Avenue at a point approximately 667 feet north of the boardwalk, running roughly parallel thereto and at right angles or perpendicular to North Carolina Avenue, there is a 20 foot wide street called Chalfonte Avenue which runs the width of the block between North and South Carolina Avenues. Between this street, Chalfonte Avenue, and the rear portion of the Chalfonte Hotel structure are located the particular properties involved in the issue herein joined. These properties consist of the following:

#1. Brick garage of 13 levels for housing the automobiles of the hotel guests capable of accommodating between 240 and 260 vehicles.

#2. New power house. This 6-story building houses a varied number of hotel services. The first floor houses all the necessary machinery for supplying electricity to both hotels. In the basement there are two artesian wells which supply all the water for all buildings of the hotels, together with a large reservoir tank for the storage thereof. On the second floor there is a carpenter shop and paint shop. The third floor contains all the heating equipment for heating all the hotel facilities. The fourth floor is used for storage while the fifth floor contains a complete laundry which services the hotels. The sixth floor is divided into rooms and serves as a dormitory for the taxpayer's male employees.

#3. Old power house used as a utility building for painting and storage.

#4. Sands Hotel (located at the corner of Chalfonte and South Carolina Avenues). This is a 6-story brick and frame hotel having 5 stores, 92 bedrooms and 23 baths. It is used principally for housing the taxpayer's female employees and can accommodate about 143 women.

#5. Martin's cottage. This is a 3½-story frame building containing 7 bedrooms and 2 baths and an apartment of three rooms and a bath.

#6. Keystone. This is a 4-story brick and frame building containing a store, 41 bedrooms and 6 baths. It is used for housing the male employees of taxpayer.

#7. This parcel consisted of properties known as Rydal, Warwick and Cedarcroft Hotels. They were small hotels fronting on South Carolina Avenue and have since been demolished.

In addition, there is a tunnel running beneath the surface of the ground starting in the Haddon Hall to the east and going under North Carolina Avenue to the new power house on the west.

These properties for the present purposes can be called the service facilities.

In 1937, the taxpayer was reorganized in this Court under Section 77B of the Bankruptcy Act. It possessed a total indebtedness of $7,906,336, including a first mortgage of $4,100,000 on Haddon Hall held by Prudential Insurance Company which was due January 1, 1952, and a first mortgage of $2,550,000 on the Chalfonte held by Camden Trust Company which was due January 1, 1952.

On December 31, 1951, the aforementioned debt of the taxpayer was reduced approximately by two million dollars leaving a total indebtedness of $5,999,635.61 of which there was still due to Prudential, $3,365,228.46 on its mortgage (a reduction of $734,771.54), and to Camden Trust, $1,960,440.00 on its mortgage (a reduction of $589,560.00).

These two mortgages, together with a chattel mortgage having a balance due of $73,964.28, were due for payment January 1st, 1952, and the taxpayer explored various possibilities for refinancing its obligations. The Camden Trust Company refused to renew or extend its mortgage, and by the fall of 1951 it became apparent to the taxpayer that it would be impossible to obtain a completely satisfactory refinancing of its debt structure. Taxpayer had secured a commitment from the Donner Foundation for a mortgage loan on the Chalfonte Hotel of $900,000 but the placing of this loan cost the plaintiff-taxpayer $175,000 in discount and placement fees. It attempted to secure a mortgage loan from Prudential of $825,000 on the hereinbefore described service facilities. (Prudential had agreed to extend its mortgage on Haddon Hall five years, until January 1st,

1957, and set the interest rate at 4½%.) Prudential informed the taxpayer that under applicable (State of New Jersey) insurance regulations it would be impossible to give an $825,000 mortgage loan on the service facilities but that they would purchase these properties for $825,000 and lease them back to taxpayer for twenty years at an annual rental of $66,000, together with a right in the taxpayer to repurchase.

On December 27, 1951, there was executed by Prudential and the taxpayer a lease agreement whereby Prudential leased to the taxpayer the service facility properties for a period of twenty years commencing January 2, 1952, for an annual rental of $66,000. Among other things, the agreement provided that the taxpayer was required to pay all real estate taxes, assessments, water rates, insurance, utilities and repairs and that the taxpayer could make such alterations and improvements to the buildings, fixtures and equipment which may be necessary or desirable. The agreement also provided that the taxpayer at any time during the term thereof had the right or option to repurchase the service facilities for the original purchase price of $825,000 less the sum of those portions of the monthly installments of rent theretofore paid, as if such rentals were allocated, first, to interest at 5% per annum calculated on the declining monthly balances, and the balances of the monthly payments of rent in reduction of the principal sum of $825,000, but in no event was the repurchase price to be less than $5,000. On December 28, 1951, the taxpayer conveyed the premises known as the service facilities to Prudential by warranty deed.

The transaction was thereafter treated by taxpayer on its books and accounts as a mortgage and the $825,000 received therefrom was entered as a liability. (See Par. 10, Stipulation.) Taxpayer, until March, 1955, treated the

transaction in its federal income tax returns as a mortgage, deducting for depreciation and interest paid on such service facilities. (See Par. 9, Stipulation.) Prudential, on its books and records and its income tax returns, treated the same as a sale. (See Par. 11, Stipulation.)

In March, 1955, taxpayer changed its legal position with the Director of Internal Revenue regarding this transaction and adopted the position that the transaction was a sale wherein it suffered a capital loss, and, consequently, at that time, filed claims for refund for the years 1950 and 1951 to recover the carry-back loss it had sustained in those years. When the Director did not dispose of the claim within six months taxpayer instituted suit.

All the above facts have been entered upon the record before the Court by Stipulation. At the time of trial the taxpayer-plaintiff rested upon the record. The government by way of defense produced a real estate expert, Edward B. Gottleib, who appraised the properties in question, as of December, 1951, and placed a valuation thereon of $1,364,539.37, together with the stipulated value of the machinery and equipment contained in the service facilities of $91,000, or a total of $1,455,539.37. Thereafter, the taxpayer-plaintiff called as a rebuttal witness H. G. Myers, likewise a real estate expert, who appraised the facilities in question, as of December, 1951, and placed a valuation thereon of $795,300, together with the stipulated $91,000 for machinery and equipment, making a total of $886,300 for the properties transferred. With this, counsel rested and have briefed the matter to the Court.

The sole question before the Court appears to be, Was the transaction hereinbefore described a sale or a mortgage? It is the contention of the taxpayer that it is, under the tax laws, a sale and they are entitled to receive credit for a capital loss. On the other hand, it is the contention

of the government that this was, in effect, a mortgage transaction and the taxpayer is not entitled to credit for a capital loss.

The applicable tax statute is Section 117(j) of the Internal Revenue Code of 1939 and reads, as follows:

> "(j) (as added by Sec. 151(b), Revenue Act of 1942, supra)
> *Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—
>
> "(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.
>
> "2. *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets."

The leading case in this particular field is Helvering v. Lazarus, 308 U. S. 252 (1939), wherein the Supreme Court affirmed a decision of the Board of Tax Appeals which upheld a taxpayer's claim for allowance of a deduction for depreciation in computation of income tax. The Court stated at page 255:

> "We think the Board justifiably concluded from its findings that the transaction between the taxpayer and the trustee bank, in written form a transfer of ownership with a lease back, was actually a loan secured by the property involved. General recognition has been given the 'established doctrine that a court of equity will treat a deed, absolute in form, as a mortgage, when it is executed as security for a loan of money'. In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding."

It is generally stated and counsel have cited a number of cases to the effect that in determining whether a particular transaction constitutes a mortgage or a sale the primary factor for consideration is the intention of the parties.

A reading of the cases cited by counsel following the Lazarus case, supra, leads one to the conclusion that each particular transaction must be examined for all the surrounding facts in order to reach a determination of whether it constitutes a legal sale or mortgage. Such an examination leads this Court to the conclusion that the transaction

herein, while in form a sale, was in fact a mortgage with the conveyed property as security for the debt.

In reaching such a determination the Court has attempted to view all factors in the matter. The picture presented in the view of the Court is, as follows:

In 1938, the taxpayer was re-organized through bankruptcy proceedings with a total capital debt of close to $8,000,000. It was in the hotel business with two contiguous hotels and the service facilities (hereinbefore described) as its capital assets. It produced its own water, heat and light. It operated its own laundry and, in the main, housed its own employees and garaged the cars of its guests. In January, 1952, the greatest portion of its capital debt became due and it was seeking either extensions thereon or refinancing.

In the meantime it had reduced its capital debt by close to $2,000,000 (from $7,906,336 to $5,999,635.61) and at the same time it would be fair to assume that the properties of the taxpayer had increased in value, or, at the very least, had not decreased in value. As a result its comparative financial picture was 25% better than it was in 1938.

Prudential held the mortgage on the Hotel Haddon Hall. Camden Trust Company held the mortgage on the Hotel Chalfonte. Camden Trust Company would not renew or extend its mortgage so the taxpayer, in addition to making arrangements for the extension of the Prudential mortgage, had to secure $1,960,440 in order to pay off the Camden Trust Company. It secured a commitment for $900,000 from the Donner Fund for a mortgage on Chalfonte, but this cost $175,000. It, therefore, had to secure $825,000 from some other source. Taxpayer turned to the lending institution familiar to it and its problems, namely, Prudential. Prudential explained why it could not advance the money on a straight mortgage but could make available the money in the manner hereinbefore described.

The arrangements were entered into and the transaction completed. In the mind of the taxpayer at that time it was a loan, for it was so treated on the taxpayer's books and income tax returns.

It is argued by the taxpayer that such action was taken upon the advice of counsel and upon the advice of its Certified Public Accountant and that such advice should not foreclose taxpayer from asserting its true position or constitute a bar to such assertion. This Court would not feel that this act, taken alone by the taxpayer, would constitute a bar to the relief it presently seeks, but it does feel that it is a fact to be taken into consideration with all other things to show the intention of the taxpayer at the time of the transaction.

There is no evidence in this record that the taxpayer had any appraisal made of the true sale value of the service facilities transferred prior to the transaction hereinbefore discussed. Is it reasonable to assume that the taxpayer would involve itself in the outright sale of all of its service facilities without availing itself of a fair appraisal of their true value? This Courts feels it is not.

There is no evidence in the record before the Court that the taxpayer made any kind of a survey before entering into this transaction of what it would cost taxpayer to subcontract for the services produced by the facilities transferred, for instance: What would it cost for water? What would it cost for laundry? Could parking facilities be obtained and at what cost? What facilities would be available for storage and repair of furniture? What would be the result of not furnishing living quarters to its help? How could they possibly obtain heat for the two hotels from some other source? What effect would these services and the cost thereof obtained from outside sources have on the operating profit or loss of the taxpayer? Is it reasonable

to assume that the taxpayer would enter into an outright sale of such facilities without first making such inquiries and survey? The Court feels that it is not.

Despite the apparent form of the transaction as a sale, the plaintiff-taxpayer continued to assume all the rights, duties and obligations of ownership to the property. It must, by the terms of the lease, pay all real estate taxes, assessments, water rates, insurance, utilities, and repairs, and can make such alterations and improvements to buildings, fixtures, and equipment which may be necessary or desirable on its part.

The repurchase price to be paid by the taxpayer is equivalent to the $825,000 on a 20-year amortizing mortgage at 5% interest plus $5,000. Is this any more than a small bonus such as would be provided for upon the pre-payment of a mortgage?

Taxpayer argues that it paid the $907.50 for the Federal Documentary Tax Stamps affixed to the deed and that this factor should be seriously considered by the Court. It seems that this pales into insignificance when it is realized that the taxpayer paid $175,000 for the mortgage of $900,000 from the Donner Fund.

Taxpayer argues that one of the conditions of the repurchase agreement was that it must pay off any balance due and owing to Prudential on the mortgage held by Prudential on Haddon Hall and that this further indicates that the transaction under consideration was a sale in fact and not a loan. The Court feels that the contrary conclusion is the more reasonable or logical one to be drawn from such circumstance. Here is a creditor and debtor relationship and the creditor, in effect, saying, now before you completely pay me off on the second debt and obtain your release (of the repurchase of the service facilities) you must also pay off the first debt.

Plaintiff-taxpayer argues, "If expert testimony as to Fair Market Value of the Property is to be admitted, the testimony of defendant's expert witness is entitled to little, if any, weight," and further, "If expert testimony as to Fair Market Value is to be admitted, the testimony of plaintiff's expert witness should be accepted."

The Court feels that the testimony regarding value is admissible but is not conclusive. It is merely an additional fact to be taken into consideration in viewing the entire picture. Naturally, the weight and credit to be given to the testimony of the two experts is for the trier of the facts, in this matter, the Court. The Court finds from a careful analysis of both experts' testimony that the testimony of the witness Gottleib is entitled to more weight and seems to be more convincing. He approached the problem with greater soundness. He did not speculate on things that did not concern him and he did not appear to have any interest in the case. On the other hand, the Court, with reluctance, cannot say the same for the witness Myers. This is best illustrated by an excerpt of his testimony, pp. 60, 61, 62, transcript:

> "Q. Well, isn't it a fact, Mr. Myers, that these facilities were a necessary adjunct to the hotel?
>
> "A. I have always thought that they could very well do without that power house. They can buy current for less than they make it.
>
> "Q. It was being used by the hotel as a power house, the garage was being used, and all the other hotels were being used so that you could not sell that property separately? You could not sell that property separately if you left the power house and sold the other property on South Carolina Avenue, isn't that the situation?
>
> "A. No, I would not say that about South Carolina

Avenue because that property could have been sold, and they would have the cost of housing their employees. All the other hotels didn't house their employees, but they did. And so far as the garage, they could certainly operate without the garage because other hotels operate without garages. If they operated without the power house building and the laundry, then they would have to make plans to send the laundry out, and to house their men in dormitories elsewhere, and obtain their current from the Atlantic City Electric Company. It isn't my judgment but I heard this from Mr. *Henry* that it cost them ten cents a kilowatt hour to make it, and they could buy it for two cents.

"Q. The power house was being used by the hotel, and the garage was also being used by the hotel?

"A. Yes.

"Q. And it was adaptable to their use because of the new dormitory to the rear, in the rear of this hotel?

"A. Yes, but they have, I presume they have immediately to the east a terrifically large parking lot where the Strand Hotel used to stand.

"Q. Yes, but that is not part of Haddon Hall?

"A. The Haddon Hall has a chance to use it as a parking lot. If they could not use that garage, they could use the parking lot.

"Q. Now, when was that appraisal made that you just testified about?

"A. Well, it was made sometime in 1958. I don't recall what month. I may have some stuff lying around here with that in it. I made it in May, 1958. I have here a letter of May 16th addressed to Mr. Murdoch."

In addition, Mr. Myers participates in the commission on insurance premiums on the hotel properties.

The Court does not give great weight to the testimony of either expert in view of their difficult task of attempting, in 1957 and 1958, to make an appraisal and give a valuation as of 1951. It attaches more significance to the lack of an appraisal or actual evaluation of the facilities by the taxpayer prior to their transfer.

Lastly, it is, in the Court's estimation, of great significance that the lease containing the repurchase or option right was signed by Prudential December 27, 1951, (see Par. 8, Stipulation), the day before the execution of the deed, December 28, 1951, (see Par. 6, Stipulation). This fact indicates to the Court that the taxpayer wanted to be assured of the legal right to have possession, control and ability to regain title before the transfer to Prudential and was secure in its position by having Prudential execute the lease before it, the taxpayer, would execute the deed.

These facts, reviewed herein by the Court, may not have the same significance to other viewers, or, other facts in the matter not reviewed here may be more important to others than those herein set forth, but it seems to the Court that at the very least these are the important factors and they all seem to point in the one direction, namely, the creation of a debt and the transfer of these service facilities as security therefor. For the foregone reasons the plaintiff's claim will fall and the action will be dismissed.

Counsel will prepare an appropriate order.

/s/ THOMAS M. MADDEN.

9/1/59

JUDGMENT.

The above-entitled cause having come on regularly for trial before this Court on February 9, 1959, the Honorable Thomas M. Madden presiding therein, sitting without a jury, plaintiff and the defendant appearing by their respective attorneys, and some of the facts having been stipulated by written stipulation entered into between the parties and filed herein, together with documentary evidence and oral testimony submitted in behalf of each party, and briefs having been filed by and in behalf of the respective parties, and the Court, having duly considered the same and having rendered its opinion and decision on September 1, 1959, in favor of the defendant, ordering dismissal of this action, it is therefore

ORDERED, ADJUDGED and DECREED that the complaint filed herein be dismissed, with costs, if any, to be assessed against plaintiff.

/s/ THOMAS M. MADDEN,
United States District Judge.

Entered September 21, 1959.
Approved as to form:
/s/ CHESTER A. WEIDENBURNER,
United States Attorney.
/s/ FRANK J. FERRY,
Assistant United States Attorney.
/s/ JAMES N. BUTLER,
Attorney for Plaintiff,

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REVENUE AND EXPENSE

. . . unrealized profit . . . installment method . . . construction-type contracts . . . government contracts . . . leases . . . compensation . . . pension plan costs . . . deferred compensation . . . depreciation . . . real and personal property taxes . . . income taxes . . . interest . . . research and development . . . contingencies

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